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# The Impact and Desirability of Taxing Unmined Coal Interests in the Same Manner as Other Real Property

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## Introduction

Controversy regarding the impact and desirability of taxing unmined coal interests in the same manner as other real property provided the impetus for this article. Deciding whether unmined coal should be taxed like other real property, taxed at special rates or not taxed at all requires making some value decisions. The purpose of this article is to examine the existing tax system to ascertain the possible impacts of taxation of unmined minerals, which in turn should make clearer the value choices which must be made by the legislature when it decides whether or not to change the existing tax system.

In order to add perspective to the issues and to examine constitutional, legal and traditional impediments and limitations to change, the article begins with a brief summary of property taxation in Kentucky and the historical development of the unmined minerals taxes in Kentucky. Part II of the article attempts to ascertain existing law on the subject at a time when the current law is being tested in the courts. Part III examines the issues relating to implementation of a tax on unmined minerals, such as valuation, the effects of the Broad Form Deed Act, and the impact on farms and minerals other than coal. These implementation issues, although rarely discussed by proponents or opponents of taxation of unmined coal, can have a profound effect on the determination of the amount of tax to be generated, the incidence of the tax, and concomitantly the fairness of the tax. Part IV of the article utilizes the assumptions and conclusions from Part III to assess the economic impact of the tax on taxpayers and on the revenues of the state. It concludes that prior scholarly attempts to estimate economic impact have been erroneous due to the failure to consider the implementation issues discussed in Part III.

## I. THE KENTUCKY *AD VALOREM* PROPERTY TAX

Kentucky's present property tax is provided for under sections 170 through 174 of the Kentucky Constitution. Under section 171, the general assembly has the power to provide an annual tax on property which "shall be levied and collected for public purposes only and shall be uniform upon all property of the same class."[1] Section 171 of the Kentucky Constitution gives the general assembly the power "to divide property into classes and to determine what class or classes of property shall be subject to local taxation."[2] Under section 172, all non-exempt property must be assessed at its fair cash value, which is the price it would bring at a fair voluntary sale.[3]

An exception to this fair cash value rule is found in section 172A. This section states that the assessment value of agricultural and horticultural land is determined according to its value for such agricultural or horticultural use rather than its fair cash value.[4] The general assembly has the power to provide for reasonable differences in the tax rate within different areas of the same taxing districts "on that class of property which includes the surface of the land."[5] Futhermore, the Supreme Court of Kentucky has held that the purpose of section 172A is to allow a lack of uniformity, both as to the tax rate and the valuation of the affected land.[6] The court also held that the power to provide for a different tax rate is not limited to agricultural or horticultural land, but includes urban land as well.[7]

The general assembly has acted on the powers granted to it by the Kentucky Constitution through Title XI of the Kentucky Revised Statutes. Title XI provides a comprehensive scheme for

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[1] KY. CONST. § 171.

[2] *Id.*

[3] KY. CONST. § 172.

[4] KY. CONST. § 172A.

[5] *Id.*

[6] City of Louisville v. Fiscal Court, 623 S.W.2d 219, 223 (Ky. 1981).

[7] *Id.*

levying, assessing, and implementing an *ad valorem* tax on non-exempt property.

In general, all property, real or personal, is subject to property tax unless specifically exempted under section 170 of the Kentucky Constitution. Under section 170, exempt property includes property used for religious worship or as a parsonage, places of burial not held for profit, public charities, educational institutions, public libraries, household goods, crops grown in the year the assessment was made, and real property used as a permanent residence of an owner who is at least 65 years old or is totally disabled.[8] The general assembly may also authorize any city or town to exempt manufacturing establishments from local taxes for up to five years as an incentive to locate there.[9] These exemptions are exclusive and any other exemption is void.[10]

All real property not exempted by section 170 of the Kentucky Constitution is subject to taxation.[11] The rate at which such property is taxed is provided for in Kentucky Revised Statutes (KRS) section 132.020. Generally, real property is subject to tax at a rate of 22 cents per $100 of assessed value,[12] but unmined coal is subject to tax at a rate of 1/10 cent per $100 of assessed value.[13] The real property rate is subject to change each year, because the rate is adjusted each year to the extent necessary to make the present year's aggregate tax 4% greater than it was in the immediately preceding year.[14] Moreover, the Attorney General has held that the increase in a particular county is not limited to 4%,[15] but that the increase for the entire state is limited to 4%.[16] The 4% limit on state increases does not apply to increases due to the addition of new property to the tax rolls.[17]

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[8] KY. CONST. § 170 (Cum. Supp. 1984).

[9] *Id.*

[10] *Id.*

[11] KY. REV. STAT. § 132.190(1)(a) (Cum. Supp. 1984) [hereinafter cited as KRS].

[12] KRS § 132.020(1) provides a 31 & 1/2 cent rate but this rate has been rolled back by the 4% limitation to 22 cents pursuant to the 1984 property tax bill.

[13] KRS § 132.020(5) (Cum. Supp. 1984).

[14] KRS § 132.020(7) (Cum. Supp. 1984).

[15] 83 Ky. Op. Att'y Gen. 17 (Ky. Jan. 1983).

[16] *Id.*

[17] KRS §§ 132.020(7), 132.010 (Cum. Supp. 1984).

The general assembly has determined that some property shall be taxable only at the state level.[18] Other than those types of property specifically listed in KRS section 132.200, all property is subject to taxation at the state level as well as by the county, city, school or other taxing district in which the property is located.[19] Among those types of property taxable only by the state is "unmined coal and any interest therein, in whatever form held."[20] Local taxing districts can only tax coal in a specially voted levy, the purpose of which is to retire bonds issued prior to 1977.[21] If the property is subject to local taxation, such taxes operate almost identically to the state real property tax. The major difference is the maximum limit on county, city and local taxing district tax rates.[22]

The property tax is administered under a two-tier system. At the state level is the Kentucky Revenue Cabinet[23] and at the county level are the Property Valuation Administrators (PVAs). The Revenue Cabinet has the power to "make rules and regulations, and direct proceedings and actions, for the administration and enforcement of all tax laws of this state."[24] The Revenue Cabinet has the power to assess the value of distilled spirits,[25] property of public service corporations,[26] capital stocks of domestic savings and loans,[27] and taxable capital[28] and reserves of domestic life insurance companies.[29] However, the Revenue Cabinet must rely on the assessments of the PVAs to determine the value of all other property subject to state *ad valorem* property tax.[30]

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[18] KRS § 132.200 (Cum. Supp. 1984).

[19] *Id.*

[20] KRS § 132.200(11) (Cum. Supp. 1984).

[21] KRS § 132.203 (Cum. Supp. 1984).

[22] KY. CONST. § 157.

[23] KRS § 12.250 (1985) (prior to July 13, 1984, the Kentucky Department of Revenue).

[24] KRS § 131.130(1) (1984).

[25] KRS § 132.160 (Cum. Supp. 1984).

[26] KRS § 136.120(3) (Cum. Supp. 1984).

[27] KRS § 136.290 (1982).

[28] KRS § 136.320(a) (1982).

[29] KRS § 136.320(c) (1982).

[30] KRS § 132.420(1) (1982).

The PVAs are the second tier of the system and they operate at the county level. There must be one PVA for each county.[31] The major duty of the PVA is as follows "subject to the direction, instruction and supervision of the [Revenue Cabinet], [the PVA shall] make the assessment of all property in his county except as otherwise provided, prepare property assessment records, and have such other powers and duties relating to assessment as may be prescribed by law or by the [revenue cabinet]."[32] The PVA also prepares property tax rolls,[33] and maintains a list of real property additions and deletions to that tax roll, for all taxable property within his county.[34]

Thus, the Revenue Cabinet has broad powers with regard to taxation of property. It levies the taxes on property, it has supervisory powers over the PVAs, and it has broad administrative powers in the taxation area. The PVAs, however, determine the value for tax purposes of almost all the property in the state.

Assessment presents recurring problems in the administration of the property tax. The PVA cannot willfully or intentionally assess one person's property at a lower or higher relative weight than he assesses the same class of property of another person.[35] Furthermore, the PVA "shall make every effort, through visits with the taxpayer, personal inspection of the property, from records, from his own knowledge, from information in property schedules, and from such other evidence as he may be able to obtain, to locate, identify, and assess property."[36] The PVA is required to revalue all real property within his county on an annual basis and to make a physical examination of the real property at least once every two years.[37]

In the recent case of *Dolan v. Land*,[38] the Kentucky Supreme Court held that even though the deputy valuator had viewed the property the assessment was invalid.[39] The majority opinion

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[31] KRS § 132.380(1) (1982).
[32] KRS § 132.420(1) (1982).
[33] KRS § 132.530(1) (1982).
[34] KRS § 132.015 (1982).
[35] KRS § 132.450(1) (Cum. Supp. 1984).
[36] *Id.*
[37] KRS § 132.690(1) (1982).
[38] 667 S.W.2d 684 (Ky. 1984).
[39] *Id.* at 688.

noted that the deputy's view of the property was for the sole purpose of comparing the property to a contour map.[40] The Court held that "the deputy valuators did not physically inspect the land."[41] Furthermore, the formula used by the PVA to determine the property's value "failed to consider the particular individual characteristics of specific farm property."[42] Arguably, the degree of physical inspection required may vary depending on the specific facts present in each case; however, it is clear that at least some level of physical inspection is required.

A key assessment issue is the criteria for valuing property. Under the Kentucky Constitution, all non-exempt property must be assessed at its fair cash value—"estimated at the price it would bring at a fair voluntary sale."[43] Although section 172 was enacted in 1898 along with the rest of the present constitution, it was not followed, with regard to the fair cash value clause, until almost 80 years later. Under a long line of cases beginning with *Eminence Distillery Co. v. Henry County Board of Sup'rs.*,[44] the Kentucky court held that to force a fair cash value assessment onto an individual taxpayer, while other taxpayers' properties of the same class were valued at a lower rate, violated sections 171, 172 and 174 of the state Constitution and the Fourteenth Amendment of the United States Constitution[45] which requires equality in taxation. The *Eminence* court remedied this inequality by lowering the assessment of the person assessed at fair cash value.[46] The court reasoned that to increase the assessment of all other taxpayers would be inequitable and would in reality be no relief at all.[47] In 1965, the Kentucky Court of Appeals (now Supreme Court) decided *Russman v. Luckett*[48] and its sister cases.[49] In *Russman*, the Court went against the

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[40] *Id.* at 687.

[41] *Id.*

[42] *Id.*

[43] KY. CONST. § 172. Such language is echoed throughout Title XI as well as in § 174 of the Constitution.

[44] 200 S.W. 347 (Ky. 1918).

[45] *Id.* at 350-51.

[46] *Id.* at 351.

[47] *Id.*

[48] 391 S.W.2d 694 (Ky. 1965).

[49] McDevitt v. Luckett, 391 S.W.2d 700 (Ky. 1965); Miller v. Layne, 391 S.W.2d 701 (Ky. 1965).

long line of cases exemplified by *Eminence* and held that the remedy was to raise all taxpayers' assessments up to fair cash value.[50] Thus, today all property must be valued at its fair cash value.

Another aspect of the assessment problem is the uniformity requirement. The Kentucky Constitution states that taxes "shall be uniform upon all property of the same class."[51] The Supreme Court of Kentucky has interpreted this to mean "that the rate of taxation must be the same for property of the same class."[52]

## II. HISTORICAL DEVELOPMENT OF UNMINED MINERALS TAX IN KENTUCKY

Subsurface minerals have been subject to taxation since Kentucky became a state in 1792. Prior to 1950, coal in-place was subject to an *ad valorem* property tax to the extent of its contribution to the overall value of the surface property.[53] The assessment value was determined through what was basically a haggling contest between the taxpayer and the Tax Assessor (now PVA).[54] Generally, the taxpayer would file a return with the Tax Assessor in which he would state a value for his interest in the minerals.[55] Next, if the Assessor disagreed with this assessment, he would revalue the property.[56] This was often followed by the taxpayer appealing this revaluation.[57] Usually, through negotiations, the two sides would eventually agree on a compromise valuation.[58] This was a workable system until the latter part of the 19th century when many of the subsurface estates were

[50] *Russman*, 391 S.W.2d at 699-700.

[51] KY. CONST. § 171.

[52] Parrent v. Fannin, 616 S.W.2d 501, 503 (Ky. 1981).

[53] Dutton & Bratton, The Feasibility and Revenue Effects of an Ad Valorem Tax on Unmined Coal 1 (Oct. 31, 1983) (unpublished report to the Kentucky Legislative Research Commission). In other words, if the surface estate was considered to be worth $1,000 per acre and the minerals *in situ* on that property were worth an additional $200 per acre, the total value of that parcel of land was $1,200 per acre.

[54] Stephens, Taxation of Coal Land in Kentucky (1983) (position paper presented to the Kentucky Unmined Minerals Tax Advisory Commission).

[55] *Id.* at 1.

[56] *Id.*

[57] *Id.*

[58] *Id.*

severed from the surface estates through the sale, lease, or devise of mineral rights.[59] Once this occurred, separate assessment and collection efforts had to be made for each category of ownership, and since many of the mineral estate owners were unknown, little tax was levied or collected from these potential taxpayers.[60]

In the early 1950's, an attempt to create some uniformity of assessments led to the development of a combination *ad valorem* property tax and severance tax.[61] Under this approach, originating in Letcher County and later adopted by six other counties with Department of Revenue support, the county was divided into zones.[62] Each zone contained coal seams of reasonably similar characteristics and each zone was given its own rate for taxing unmined coal within that zone.[63] All unmined minerals were taxed at the zone rate, while mined minerals were taxed at ten times the zone rate.[64] For example, if a person owned 100 acres of land containing unmined coal in a zone with a rate of $50.00 per acre and he mined 10 of those acres, he would be taxed at $50.00 per acre on 90 acres and at $500.00 per acre on 10 acres.[65]

### A. *1976-78: A State Tax on Unmined Minerals*

A significant change occurred in Kentucky's real property tax program in 1976 when the Kentucky General Assembly passed House Bill 677.[66] This legislation established, for the first time in Kentucky, a separate property tax for unmined minerals. House Bill 677 levied a tax on unmined minerals at the rate of $.315 per $100 of assessed value.[67] No local tax could be levied on unmined coal under this bill unless such a levy was already in effect.[68] The bill placed responsibility for the task of assess-

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[59] KENTUCKY FAIR TAX COALITION, TAXING UNMINED MINERALS IN KENTUCKY: QUESTIONS AND ANSWERS 7 (Oct. 1983) [hereinafter cited as *Questions*].

[60] *Id.* at 5.

[61] Stephens, *supra* note 54, at 5, 6.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] H.B. 677, Ky. Gen. Assembly, Reg. Sess. (1976).

[67] Dutton & Bratton, *supra* note 53, at 1.

[68] *Id.* at 1 n.2.

ment in the hands of the state Revenue Cabinet.[69] This allowed for greater uniformity and consistency in the valuation process because the Revenue Cabinet was more insulated from local political pressures and had access to individuals who possessed the requisite expertise to effectively assess unmined coal.

In 1977, the first year of the state controlled assessment program, the Revenue Cabinet used documents such as severance tax records and lease records in order to develop a list of potential subsurface coal owners.[70] From these records a list of 8,300 names was generated. Forms were sent to these potential owners asking for information about ownership, tracts of land, and coal holdings.[71] Of the 8,300 forms sent, 750 were returned undelivered and 2,600 were completed and returned in a useable manner.[72] By looking at information from other sources, the Cabinet was able to assess 4,400 of the potential 8,300 coal property owners in the first year.[73]

The assessment efforts of the Revenue Cabinet were fruitful. The assessed value of unmined coal increased by approximately $100 million during the first year of state control.[74] In 1976, one year prior to the start of the state effort, unmined coal was assessed at $109 million; that figure almost doubled in 1977 increasing to $209 million.[75]

One flaw in the 1977 assessment procedure was that the entire acreage of unmined coal was assessed at full tonnage, as it was assumed that none of the coal had been previously mined.[76] However, an appeals procedure was initiated in order to deal with any possible overassessments.[77] Through the appeals procedure, if a taxpayer could show that some of the acres had already been mined, the assessment could be adjusted accord-

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[69] *Id.* at 1.

[70] Testimony of Virgil D. Barnard III, Kentucky Revenue Cabinet, before the Unmined Mineral Commission at 2 (n.d.).

[71] *Id.* at 2-3.

[72] *Id.* at 3.

[73] *Id.* at 4.

[74] *Id.* at 5.

[75] According to the 1982 Certification of Equalized Assessment from the Kentucky Revenue Cabinet, the assessment of unmined coal for 1977 was actually closer to $213 million.

[76] Barnard, *supra* note 70, at 6.

[77] *Id.* at 5-6.

ingly.[78] One problem with this approach is that many coal owners might not have known about or might have considered it unduly burdensome to go through the appeals procedure. As a result, the 1977 assessment data is probably not entirely accurate.

A more precise mapping effort was undertaken in the second year of the state controlled assessment process. Representatives of the Revenue Cabinet visited every county and met with coal operators, land owners and other parties in order to expand the list of 4400 coal land owners developed in 1977. New coal area maps were developed by using this additional data in conjunction with United States Geological Survey maps.[79] Coal areas were designated in each county and a face value per acre was assigned to each area.[80]

For primary seams, a value per acre was placed on the number of coal acres reported by the owner.[81] If active mining was occurring, that value was multiplied by 10 in order to establish a current value for active coal. A percentage of primary seam value was placed on secondary seams based on information gathered from landowners and coal operators.[82] The number of coal land holdings that were assessed increased from 4,400 in 1977 to 6,000 in 1978.[83] The total assessment in the final year of state control was $278 million.[84]

### B. *1978: Nominal Tax Rate and Local Assessment*

Senate Bill 309 returned the responsibility of assessing unmined coal to the local PVA and reduced the tax rate from $.315 per $100 of value to $.001 per $100 of value.[85] Since the passage of this bill, local PVAs have had the responsibility for updating coal area maps that were developed during the previous state-controlled effect.[86] The lowering of the rate of tax on

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[78] *See id.* at 6.
[79] *Id.* at 7.
[80] *Id.* at 7-8.
[81] *Id.* at 8.
[82] *Id.*
[83] Barnard, *supra* note 70, at 9.
[84] *Id.*
[85] S.B. 309, Ky. Gen. Assembly, Reg. Sess. (1978).
[86] *See* Dutton, *supra* note 53, at 2.

unmined coal has reduced the incentive of the PVA to actively continue updating assessments. Although unmined coal assessments have increased from $279 million in 1978 to $318 million in 1982, some counties which showed large assessments in 1978 showed a $-0- assessment in 1982.[87] Even with the slightly larger tax base, revenues from the unmined minerals tax declined from $673,000 in 1977 to about $3,000 in 1982.[88]

*C. 1982 and 1984: Legislative Attempts to Tax Unmined Minerals*

There have been two attempts to pass an unmined minerals tax in the last four years. The first attempt was House Bill 549 (HB 549) which was introduced during the 1982 session of the General Assembly. This bill proposed several changes to Title XI of the KRS. These changes would have created an *ad valorem* tax on all unmined minerals at the same real property rate as applies to other real property. House Bill 549 proposed to redefine real property to include unmined minerals and to eliminate KRS section 132.020(5), thus subjecting unmined minerals to the general real property tax rate.[89] This bill would have also avoided any possible problems resulting from the 4% inflationary limit placed on the increase to the aggregate assessed value of all property already on the tax rolls under KRS section 132.020(7). This would have been accomplished by amending that section to exclude from the 4% cap "the increase caused by the assessment of unmined minerals . . . prior to January 1, 1987."[90] Furthermore, the unmined minerals were to be treated as new property and so would not be subject to the 4% limitation.[91]

Under HB 549, unmined minerals would have been divided into two types: non-extractable and extractable. " 'Non-extract-

[87] Henderson County went from over $21 million to $-0- and Breathitt County went from over $14 million to $-0- between 1978 and 1982. *Id.* at 6.

[88] *Id.* at 3.

[89] H.B. 549, Ky. Gen. Assembly, Reg. Sess. § 1(3) (1982). [Although H.B. 549 was originally introduced Feb. 18, 1982 by Representatives Little and Donnermeyer, the cites herein refer to the March 15, 1982 version substituted by The House Committee on Appropriations and Revenue. Ed.]

[90] *Id.* § 2(7).

[91] *Id.* § 1(8)(i).

able unmined mineral interest' means any fee simple interest in unmined minerals of less than one hundred (100) contiguous acres owned by a taxpayer not engaged in the business of extracting or leasing for extraction unmined minerals."[92] Extractable unmined minerals would be all other interests in unmined minerals.[93] Non-extractable unmined minerals would be subject to tax at the rate of $.001 per $100 value, while extractable unmined minerals would be taxed at $.315 per $100 value.[94] Thus, tracts of less than 100 acres owned in fee simple by taxpayers not in the "coal business" were effectively excluded from taxation through application of the nominal tax rate.

Other "effective exclusions" from the tax resulted from deeming the value of unmined minerals to be $-0- in certain instances where: (1) the owner of the surface estate is also the owner of the mineral estate; the surface is used for farming, residential, commercial, or other purposes inconsistent with the extraction of the minerals; and the owner has not leased a portion of his mineral estate; (2) the land is depleted or barren; (3) the minerals cannot be extracted due to geological, economic, or legal reasons.[95] These exclusions serve to protect surface owners who are making their living or residing on the land and have no intention or desire to mine the minerals below the surface. They also prevent owners from being taxed on minerals that are not present or that cannot be extracted.

Another change that HB 549 would have brought about was the return of the responsibility for assessing unmined minerals from the local PVA to the Revenue Cabinet.[96] However, the PVA would still assess all of the tangible property such as preparation plants and tipples.[97] Such a change would help to provide a more uniform assessment of unmined minerals throughout the state and yet leave to the local PVA assessment of tangible property which could often be best accomplished by inspection.

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[92] *Id.* § 1(17).

[93] *Id.*

[94] *Id.* § 2(5).

[95] H.B. 549, Ky. Gen. Assembly, Reg. Sess. § 7(1) (1982).

[96] *Id.* § 6(2).

[97] *Id.* § 6(5).

Even with its "exclusions," HB 549 was unsuccessful, failing to pass the House after much debate and amendment in committee and on the House floor.[98] However, the proponents of an unmined minerals tax did not give up. On the first day of the 1984 General Assembly, House Bill 92 (HB 92), a pre-filed bill, was introduced in the House. Like its predecessor HB 549, HB 92 was an attempt to tax unmined minerals at the same rate as other real property by redefining real property to include unmined minerals.[99]

However, there were some differences between HB 92 and HB 549. HB 92 tended to be broader in its reach and more flexible than HB 549. For example, in HB 549, the guidelines placed on the Revenue Cabinet for assessing the value of the unmined minerals were fairly explicit.[100] On the other hand, in HB 92, the Department of Revenue is required to assess the minerals "according to valuation methods that fairly establish the actual value of mineral properties."[101]

There are two other important differences between HB 92 and HB 549. The first of these is the classification of mineral interests. Under HB 549, mineral interests were merely classified as either extractable or non-extractable.[102] Under HB 92, mineral interests are divided into four classes. First, " 'active mining property' means a mineral seam on a parcel involved in a mining operation. . . . The active mining portion of each seam on a parcel is . . . (750) acres."[103] Second, " 'active reserves' means the residual part of the mineral seam or seams which are actively being mined in excess of the active mining acreage or the number of acres corresponding to . . . (25) years of production, whichever is less."[104] Third, " 'inactive reserve' means those seams of minerals which are mineable and merchantable but are not being produced in an active mining operation or are not assignable to an active reserve property."[105] Finally, " 'barren or mined out'

[98] 15 LEG. REC. 61, 138 (Apr. 20, 1982).
[99] H.B. 92, Ky. Gen. Assembly, Reg. Sess. § 1(3) (1984).
[100] *See* H.B. 549, Ky. Gen. Assembly, Reg. Sess. § 6(2) (1982).
[101] H.B. 92, § 6(2).
[102] H.B. 549, § 1(17).
[103] H.B. 92, § 1(19).
[104] *Id.* § 1(20).
[105] *Id.* § 1(21).

property means those seams of minerals which have been depleted by prior mining operations or the existence of one (1) or more mineral seams have not been established."[106] In valuing mineral properties, the Revenue Cabinet is to take into consideration the above classifications.[107]

The second important difference between the bills is that HB 92 does not provide any of the "exclusions" from the unmined minerals tax provided in HB 549. Under HB 92, property such as farms and property of less than 100 acres is subject to tax at a rate of $.315 per $100 of value. However, such mineral property would likely be given little value as "inactive reserve property."[108]

HB 92 met with even less success in the legislature than its predecessor. After it was introduced, HB 92 was sent to the Appropriations and Revenue Committee, from which it was not reported out.[109]

Legislative attempts to tax unmined coal at the same rates as other real property have not been successful. However, proponents of such taxation have been successful in obtaining a decision by the Franklin Circuit Court that the present 1/10 cent tax rate on unmined coal constitutes an unconstitutional exemption of unmined coal from taxation.[110]

## III. LEGALITY OF THE CURRENT TAX REGIME FOR UNMINED COAL

In three recent suits, the present regime of taxation of unmined coal was challenged.[111] These cases raise three basic issues regarding current taxation of unmined coal: (1) whether the present law is being properly administered, (2) whether the 1/10

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[106] *Id.* § 1(22).

[107] *Id.* § 6(2).

[108] West Virginia has the same classifications of mineral properties in their tax statute as was proposed in H.B. 92. Inactive reserve properties are generally valued at approximately $300 per acre in West Virginia.

[109] 16 LEG. REC. 64, 67 (1984).

[110] Moore v. Gillis, No. 84-CI-0867, slip op. (Ky. Franklin Cir. Ct. July 10, 1985).

[111] Nowak v. Foster, No. C84-0057 P(J) (W.D. Ky. filed Feb. 17, 1984); Yount v. Gillis, No. 84-CI-0815, slip op. (Franklin Cir. Ct., July 10, 1985); Moore v. Gillis, No. 84-CI-0867, slip op. (Franklin Cir. Ct., July 10, 1985). *Yount* and *Moore* were consolidated by the Supreme Court.

cent tax rate on unmined coal violates constitutional requirements of uniformity, and (3) whether the 1/10 cent tax rate on unmined coal constitutes a de facto exemption from property tax in violation of the Kentucky Constitution.

*Nowak v. Foster* raised the issue of whether the PVAs were improperly administering the statute by failing to assess unmined coal within their counties.[112] Since the tax would produce less revenue than it costs to assess the coal, it is not surprising that the PVAs failed to assess the coal within their county. This issue will probably never be resolved if the 1/10 cent tax rate on coal is held unconstitutional, since the PVAs or anyone else charged with assessing unmined coal would undoubtedly do so if unmined coal were taxed at rates which produced substantial revenues.

The uniformity argument is based upon the fact that unmined coal is taxed differently under the current statutes than is other real property, including oil and gas.[113] In *Yount v. Gillis*,[114] the gravamen of the complaint was that the provision in KRS section 132.020(5) which sets the tax rate on unmined coal at 1/10 cent per $100 of value violated section 171 of the Kentucky Constitution.[115] Section 171 provides that taxation shall be uniform upon property of the same class subject to taxation within the territorial limits of the authority levying the taxes.[116] In *Moore*, the plaintiffs argued that KRS section 132.020(5) violated the equal protection provisions in the Kentucky Constitution.[117] They argued that no rational basis exists for the legislative classification of unmined coal at a rate of taxation of 1/10 cent while oil and gas are taxed at the same rate as other real property.[118]

It appears that legislative classification of unmined coal separate from other real property, including oil and gas, is constitutional. To be constitutional, the legislative tax classification

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[112] No. C84-0057 P(J) at 2; *see also* Note, *Taxation of Unmined Minerals: Is It Inevitable, or Is it Unconstitutional*, 1 J. MIN. L. & POL'Y 97 (1985).

[113] *See Nowak*, No. C84-0057 P(J) at 2.

[114] No. 84-CI-0815, slip op. (Franklin Cir. Ct. July 10, 1984).

[115] *Id.* at 2.

[116] KY. CONST. § 171.

[117] *Moore*, No. 84-CI-0867 at 3; KY. CONST. § 1.

[118] *Moore*, No. 84-CI-0867 at 3.

must have a reasonable relation to some permitted end of government—the classification must not be arbitrary and unreasonable.[119] Unmined coal is unlike other real property in that unmined coal has basically only a future potential beneficial use. Realty, however, can be rented or used by the owner to obtain present enjoyment. Unmined coal is also different from oil and gas in that unmined coal is stationary, while oil and gas deposits can flow from beneath one property and be depleted by wells on neighboring properties. Because oil and gas is usually found in pools or pockets, there is little likelihood of property being assessed for oil and gas deposits based upon estimates of oil deposits on nearby properties. Oil and gas deposit assessments are likely to be based upon the existence of one or more operating wells on the property. Thus, there appear to be sufficient differences between unmined coal and other real property to constitutionally justify a separate classification for tax purposes.

In *Moore*, the complainants relied on sections 3 and 174 of the Kentucky Constitution to support their claim that KRS section 132.020(5) provides an unconstitutional *de facto* exemption of unmined coal from state property tax.[120] They argued that "the levy upon unmined coal is so low, especially in relation to the costs of its administration and collection, that it cannot be fairly called a tax."[121] For example, unmined coal with a value of $100,000 has a tax of $1 levied on it under KRS section 132.020(5) and the complainants argue, "such a low rate strips a levy of its revenue generating characteristics . . . rendering it no longer a tax."[122]

Another argument was that such a low rate of tax "makes it financially imprudent for the Revenue Cabinet or Kentucky's PVAs to assess or collect the levy because the cost of administration exceeds the yield."[123] Such expenses would be at least $400,000 per year, which is about 153 times greater than the

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[119] *See, e.g.*, *Yount*, No. 84-CI-0815 at 5 (partial summary judgment holding KRS § 132.020(5) not in violation of KY. CONST. § 171).

[120] *Moore*, No. 84-0867 at 2, 3.

[121] Brief for Plaintiff at 2, Moore v. Gillis, No. 84-CI-0867 (Franklin Cir. Ct., July 10, 1985).

[122] *Id.* at 10.

[123] *Id.*

revenue generated from the tax. Sections 3 and 174 of the Kentucky Constitution prohibit exemption of property from state tax (unless exempted under section 170 of the Kentucky Constitution) and since KRS section 132.020(5) arguably creates a *de facto* exemption from state tax, it was contended that it was unconstitutional.[124]

On July 24, 1985, final judgment was rendered in favor of plaintiffs. The court held KRS section 132.020(5) unconstitutional on the grounds that it did not constitute a tax and thus violated sections 3 and 174 of the Kentucky Constitution.[125] Cabinet Secretary Gillis is reported to be appealing this decision to the Court of Appeals.[126]

The *Moore* decision raises the question of whether the legislature may do indirectly what it cannot do directly (exempt unmined coal from tax) and, if not, when is a tax so low as not to constitute a tax in substance? For example, would a property tax rate of 2 cents per $100 of value be so low as not to constitute a tax? Is the test whether the tax produces revenue in excess of the costs of administration or must such excess net revenues generated be "meaningful" in amount or in relation to the value of the property being taxed?

Another question raised by the *Moore* decision is whether application of the 1/10 cent rate per $100 of value to other property, such as pensions, bank deposits and farm implements,[127] is unconstitutional. The 1/10 cent rate could be unconstitutional when applied to unmined coal, but constitutional when applied to some other interest such as vested pension benefits which might not be "property" for tax purposes.[128] Vested pension benefits are "property" for purposes of divorce, but they might not be "property" for tax purposes since, in general, they cannot be sold, exchanged, cashed-in, assigned or used as security for a loan before maturity, and their disposition

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[124] *Moore*, No. 84-CI-0867 at 11 (holding the 1/10 cent levy was not a tax, therefore violating KY. CONST. §§ 3, 174).

[125] *Id.*

[126] Ky. Coal J., Aug. 1985, at 3.

[127] *See generally* KRS § 132.020 (Cum. Supp. 1984) (setting forth ad valorem taxes assessed by the state).

[128] *Cf.* Commonwealth v. Kentucky Distilleries & Warehouse Co., 116 S.W. 766 (Ky. 1909) (holding a trademark not "property" for purposes of the KY. CONST. § 174).

on death of the owner is greatly limited by the Retirement Equity Act of 1984.[129] Although unmined coal, like pension plans, arguably produces no current benefit to the owner, unmined coal can be sold, exchanged or used as security for a loan, and can be transferred at death like other real property.[130]

## IV. SPECULATIVE VALUATION OF UNMINED COAL

While assessments of realty, oil, and gas values involve some subjective determinations on the part of the PVA, the valuation of unmined minerals is much more speculative in nature. This is due basically to two factors: (1) there is a scarcity of objective data on the exact location, quantity and quality of unmined minerals under any particular tract of land and (2) the lack of comparable sales, necessitating estimates of net profits to be realized on the mining of such coal at some uncertain future time. Perhaps this speculative nature can best be seen by comparing the assessment of unmined coal with the assessment of farm land.

With farm land, as with most real property, the PVA can physically inspect the asset directly. The PVA is required to physically inspect all real property once every two years.[131] He can also obtain information from the owner who has first hand knowledge of the asset. The PVA can also consider sales of similar property and prior sales of the same property when trying to assess the value of the farm land. Even when information is needed which cannot be obtained through observation, the methods used to obtain such information are relatively inexpensive and place no real burden on the assessor or the landowner.

For example, it may be necessary to ascertain the type and condition of the soil or the slope of the land in order to determine which crop is most suited to be grown on a particular piece of farm land. In *Dolan v. Land*,[132] the PVA was able to use

[129] Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (codified in scattered sections of 26 U.S.C. and 29 U.S.C.).

[130] Note, *Taxation of Unmined Minerals: Is It Inevitable, or Is It Unconstitutional?*, 1 J. MIN. L. & POL'Y 97, 116-20 (1985) (a detailed discussion of the "property" issue as it relates to taxation of unmined coal in Kentucky).

[131] KRS § 132.690 (1982).

[132] 667 S.W.2d 684, 689 (Ky. 1984) (Gant, J. dissenting).

books and survey maps which contained a complete analysis of the farm's slope and soil type. "From the College of Agriculture at the University of Kentucky, Dolan obtained all pertinent data relating to crops grown in Fayette County and the type of soil and slope best suited for each. These records included cost of planting and return, or yield on each crop."[133] Thus, in *Dolan*, all the necessary information was already compiled by prior research and surveys. However, even if the PVA had to acquire all this information for the first time, such information could be acquired at relatively low cost.

It is much more difficult, if not impossible, to get an accurate assessment of the actual value of unmined coal without extensive and expensive testing and sampling. "[D]espite the existence of governmental and industrial zone maps and surveys, estimates of the exact location of the underground coal as well as its quantity and quality are largely guesswork."[134] The Kentucky Geologic survey estimates 5 billion tons of "measured reserves" (within 1/4 mile of measured coal reserves), 21 billion tons of "indicated reserves" (within 3/4 mile of measured coal) and 38 billion tons of estimated coal (within 3 miles of measured coal).[135]

Although it may be statistically accurate to estimate coal reserves for the entire state using such methods,[136] there is much less certainty that the estimated coal reserves in any particular location are accurate. Even if the location of the coal can be determined, valuation is not easy. The characteristics and value of an acre of coal may vary significantly from a different acre of coal located within close proximity,[137] because the value of a coal deposit is dependent to a great extent on the thickness of the coal seam and coal seam thickness can vary greatly within short distances.

There is a whole panoply of factors which may affect the actual value of the coal. Among these factors are: is there

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[133] *Id.*

[134] Whiteside & Buechel, *Kentucky Taxation*, 65 KY. L.J. 425, 430 (1976-77).

[135] Ky. Coal J., Aug. 1985, at 3.

[136] Over estimates of actual coal in one area may be offset by under estimates in another area.

[137] Stephens, Taxation of Coal Land in Kentucky 2 (1983) (position paper presented to the Kentucky Unmined Mineral Tax Advisory Commission).

enough coal in the tract to justify extraction; what is the BTU content of the coal; what is the seam thickness; what impurities are present in the coal; how accessible is the coal for mining; what will reclamation costs be; can necessary surface rights be acquired; what will transportation costs be; is there available labor; and is there a market for the coal?[138] This is not an exhaustive list of factors, but it is sufficient to give some idea of the speculative nature of assessing the value of unmined minerals.

In both HB 92 and HB 549 attempts were made to deal with these problems. Under HB 92, the Revenue Cabinet was to determine the fair cash value of all unmined minerals "according to valuation methods that fairly establish the actual value of mineral properties."[139] Under HB 549, the Revenue Cabinet was to determine the fair cash value of the unmined minerals "in the same manner and according to the same standards" as if the PVA had valued the property.[140] Furthermore, emphasis would be given to estimates of the Kentucky Geological Survey and the Institute for Mining and Mineral Research in determining the quantity and quality of the minerals.[141]

Other factors to be used in determining the value of the unmined minerals include taxpayers' maps and records, sales of similar interests, current market prices for the extracted minerals, availability of transportation and preparation facilities, BTU, sulphur and ash content, and the degree to which the minerals are under production or could be put into immediate production.[142] Even with the available data and the best intentions, assessment of unmined coal *on a particular tract of land*, without core drilling or gamma ray density tests, would not approach the accuracy of assessment of surface land in most cases.

If the location, quantity and quality of farm land in a particular tract were ascertained, the value of the farm land could be estimated by comparison with recent sales of similar farm land and prior sales of the same farm land. Although all

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[138] *Id.*

[139] H.B. 92, Ky. Gen. Assembly, Reg. Sess. § 6(2) (1984).

[140] H.B. 549, Ky. Gen. Assembly, Reg. Sess. § 6(2) (1982).

[141] *Id.*

[142] *Id.*

farm land is unique, there is a likelihood of greater similarity between two pieces of farm land then there is between two tracts of unmined coal. Furthermore, there is a greater likelihood of finding comparable or prior sales of farm land than comparable or prior sales of unmined coal. Even if such comparable sales of farm land did not exist, the present income potential of the farm land could be capitalized to estimate fair cash value. Unmined coal, other than coal being actively mined, has present value only if it can be sold now or profitably exploited in the future.

With a lack of comparable sales of unmined coal, it becomes necessary to estimate future profits from exploitation of the unmined coal and discount those future profits down to present value. Estimating profits on the exploitation of the coal at some uncertain future date is obviously more speculative than estimating current rental value or income generating potential of farm land. Present value of unmined coal deposits based upon future profitability requires estimates of several factors, including, but not limited to: future prices for coal;[143] future costs of coal production;[144] time when the coal will be extracted;[145] and a fair discount rate.

The problem of valuing unmined minerals is of particular importance since the Kentucky Constitution requires that property be valued at its fair cash value.[146] Due to its nature, the assessment of the fair cash value of unmined coal is a much more difficult and expensive process than the assessment of other types of property. There are several variables which will affect the value of the unmined coal. Some of these variables, such as transportation costs, cannot actually be determined until some indefinite future date. Opponents of an unmined minerals tax have argued that such factors make it impossible for the fair cash value of unmined coal to be determined, and therefore a tax on unmined coal would be unconstitutional.

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[143] Prices will depend in part on availability of energy substitutes, coal supply and demand. *See* P. SAMUELSON, ECONOMICS (11th ed. 1980).

[144] *E.g.*, costs of mining, transportation, reclamation.

[145] Obviously, $500,000 in profits 50 years from now is worth less than $500,000 in profits 10 years from now. If Kentucky's coal reserves will last 200 years, what is the present value of coal that will be mined 100 years from now?

[146] KY. CONST. § 172.

The HB 92 solution to these valuation problems is to create four classes of unmined coal.[147] Only active mining property and active reserves would be valued at or near the going price for unmined minerals. Obviously, the timing element of valuation is easiest for active mining property—it is possible to estimate at current rates of production the time period necessary to mine out the coal deposit. Since production is currently taking place, the need to make estimates of future coal prices and costs at some uncertain future date is minimized.

Inactive reserves would probably be valued on a per acre basis under HB 92.[148] This lower value would often, but not always, be consistent with the greater discount to present value for coal that is not mineable under present economic circumstances. If there is error in the estimation of fair cash value, the error should be on the side of undervaluation in order to avoid irreparable harm to individual taxpayers.

The consequence of the HB 92 four tier valuation system would be much like an increase in the severance tax, with the burden of the tax falling primarily on current and near future production. Both the long-term investor, who leaves his reserves inactive, and the coal owner, who cannot now economically mine his reserves, would have their coal valued in the more favorable inactive reserve category.

## V. EFFECTS OF THE BROAD FORM DEED ACT ON UNMINED MINERALS TAX

In February, 1984, the General Assembly passed the Broad Form Deed Act (the Act).[149] This act created four new sections in chapter 381 of the KRS. Under the Act, all past, present and future instruments which sever a mineral estate from a surface estate, and which fail to specifically state how the mineral is to be extracted, shall be held, in the absence of contrary evidence, to mean "that the intention of the parties to the instrument was that the coal be extracted only by the method or methods of commercial coal extraction commonly known to be in use in

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[147] *See supra* notes 103-07 and accompanying text.

[148] *See supra* note 108 and accompanying text.

[149] 1984 KY. ACTS ch. 28.

Kentucky in the area affected at the time the instrument was executed."[150] In most cases, this effectively prevents the operator or the mineral owner from extracting the coal through surface mining techniques such as strip mining and open pit mining, unless the surface owner agrees to such methods, since most of the mineral deeds were signed before the advent of such surface mining techniques.[151] Prior to the Act, the general rule in Kentucky had been that the surface estate was subservient to the mineral estate, and that the coal operator or mineral owner could use any method he chose to extract the coal.[152]

The Act has been the subject of much argument in the coal industry regarding its constitutionality. Among the arguments against the Act's constitutionality are those presented by John S. Palmore, former Chief Justice of the Kentucky Supreme Court, in his brief for the intervenors in the U.S. District Court case of *Akers v. Baldwin*.[153] Palmore argued: (1) that the Act unconstitutionally infringes upon the exclusive prerogative of the judicial branch to construe deeds and instruments already in effect; (2) the act constitutes a violation of Section 14 of the Kentucky Constitution and Article 1, section 10 of the Federal Constitution which prohibit laws which impair the obligation of contracts; (3) the Act deprives the mineral owner of his property without due process of law; and (4) the Act constitutes a taking of the mineral owner's property without just compensation.[154]

One Circuit Court has upheld the constitutionality of the Act.[155] In reaching this result, Judge Manis stated that "[a]n unconstitutional taking would occur where the rights that were bargained for are thereafter taken away. Here, that is simply not the case. The statutes protect the rights actually bargained for."[156] The U.S. District Court has certified to the Kentucky

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[150] KRS § 381.935 (Cum. Supp. 1984).

[151] *But see Strip Mining New?*, Ky. Coal J., May 1985, at 3 (where it is claimed that strip mining (horse drawn plows) began in 1870 in Kentucky and that a steam shovel was first used in Kansas in 1877).

[152] *See* Martin v. Kentucky Oak Mining Co., 429 S.W.2d 395 (Ky. 1968). *But cf.* Commerce Union Bank v. Kinkade, 540 S.W.2d 861 (Ky. 1976).

[153] Brief for intervenors, Akers v. Baldwin, No. 84-88 (E.D. Ky. 1985).

[154] *Id.* at 21-43; *see also The Coal Operators*, Ky. Coal J., May 1985, at 13.

[155] Baker v. Wooten, No. 83-CI-429, slip op. (Ky. Perry Co. Cir. Ct. Apr. 3, 1985).

[156] *Id.* at 8.

Supreme Court the issue of whether the Act violates the Kentucky Constitution.[157] The issue will be decided within the next few weeks.

If the Broad Form Deed Act is found to be constitutional, then another issue is raised: can a surface owner enjoin a coal operator or mineral estate owner from mining the land when the property rights of each side are in dispute, or is the surface owner merely entitled to damages? Whether the remedy is damages or injunction could dramatically affect the valuation of unmined coal. At present, it would appear that the surface owner can enjoin the operators from extracting coal through surface mining. The factors which influenced the Court in *Akers v. Baldwin* to issue a preliminary injunction pending determination of the constitutionality of the Act would arguably favor giving the surface owner a right to enjoin strip mining of his land if the Act is constitutional.[158]

Assuming the Act is constitutional, and that the surface owner would be entitled to injunctive relief, the question becomes what effect would this Act have on an *ad valorem* unmined minerals tax? Under the Act, it would be possible to have a situation where no one party would have the right to strip mine the minerals.[159] For example, the owner of a mineral estate contracts with an operator to mine his coal. The operator wants to strip mine the coal, but strip mining was not a common method used to extract coal when the deed severing the mineral estate from the surface estate was executed, and the present surface owner refuses to agree to extraction by strip mining. The coal cannot be legally extracted by strip mining.[160]

The coal reserves in the above example could be valued for tax purposes at close to zero value,[161] or at market value, dis-

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[157] Akers v. Baldwin, No. 85-SC-392CL (Ky. May 23, 1985) (order granting certification and granting transfer).

[158] Akers v. Baldwin, No. 84-88, slip op. (E.D. Ky. Feb. 28, 1985) (preliminary injunction filed concurrently with opinion); *see also* Short, *A Summary of The Order*, Ky. Coal J., Apr. 1985, at 5.

[159] *Cf. The Legal Right to Mine Interfaces With a Tax on Unmined Coal*, Ky. Coal J., Apr. 1985, at 4.

[160] The owner of the mineral estate would have the right to deep mine the coal but deep mining may be impossible or economically impracticable due to the higher costs of deep mining.

[161] *See supra* note 159.

regarding the need for both the surface owner and the mineral estate owner to agree to exploitation of the coal by strip mining.[162] Obviously, the mineral estate by itself is nearly worthless if strip mining is the only economical method of extracting the coal. Similarly, the interest of the surface owner in the mineral estate, by itself, even if it could be characterized as a property interest, is nearly worthless. However, since they could realize the full value of the mineral interest by acting in concert, it is reasonable that they should share the property tax burden equally.[163] The mineral owner would be liable for property tax on one-half the full value of the unmined minerals without regard to the surface owner's power to prevent strip mining. The surface owner would not be liable for any property tax on the unmined minerals, but the value of his surface estate would be increased by an amount equal to one-half the full value of the unmined minerals to reflect the additional value of the surface estate attributable to the fact that the power to control strip mining is one of the valuable attributes of the surface estate. No special legislation would be needed to accomplish this result since these are arguably fair estimates of the fair cash value of the mineral estate and the surface estate.

## VI. IMPACT OF AN UNMINED MINERALS TAX ON FARMS

If an unmined minerals tax becomes law in Kentucky, a question arises as to whether unmined minerals in all situations should be subject to such a tax. Although there is no exemption under HB 92 for minerals beneath a factory or residence owned

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[162] *Compare* KY. CONST. § 172 requiring that all property be valued at "fair cash value." Fair cash value is the price that the property would bring at a voluntary sale. KRS § 132.190(3) (1984); Kenmont Coal Co. v. Perry County Bd. of Supervisors, 91 S.W.2d 47, 48 (Ky. 1936); Kentucky River Coal Corp. v. Knott County, 59 S.W.2d 1002, 1003 (Ky. 1933). Arguably, fair cash value of such a mineral estate is close to zero and thus should be subject only to minimal tax. The only buyer of either the mineral estate interest or the surface estate consent interest is one who already owns one of those interests or one who is buying both simultaneously. In either event, the buyer is under "compulsion" to buy to prevent the other interest from being worthless. Such compulsion is arguably inconsistent with the concept of a voluntary sale.

[163] There are several situations under Federal estate tax law where a pro rata share of the property is included in the decedent's estate. *E.g.*, I.R.C. § 2040 (1979 & Supp. 1985) (certain joint tenancies), I.R.C. § 2041 (1979) (jointly held general power of appointment).

by the owner of the factory or residence, presumably such minerals would add minimal value to the property, because they would be economically unmineable. The problem is different for farms and other tracts of land with large acreage, where the value of the underlying minerals might be substantial and might even exceed the value of the surface estate.

Should a farmer have to pay taxes on coal located beneath his farm when he owns both the surface and mineral estates in fee, but he makes his living by farming the land, and has no intention of ever extracting the coal or of allowing anyone else to extract the coal? It is unclear how such circumstances would be treated under HB 92. It may be helpful to consider how such a situation would be treated under HB 549 and under West Virginia's law taxing unmined minerals.

House Bill 549 contained several "exemptions" that would have allowed certain properties to be taxed at the old rate of 1/10 cent per $100 of value, or that would have caused the minerals to have a deemed fair cash value of zero.[164] Among these was section 7(1)(a), which deemed unmined minerals to have a value of zero if: (1) the taxpayer held a fee simple interest in both the surface and mineral estates; (2) the surface was used for agricultural or horticultural purposes; (3) the taxpayer had not leased out the right to extract the minerals within five years; (4) there was no portion of the mineral estate presently under lease; (5) the owner had not extracted any minerals; and (6) the owner was not in the business of extracting or leasing for extraction unmined minerals.[165] Assuming no minerals had been extracted or leased out for extraction, the unmined minerals would be deemed to have a fair cash value of zero if the "agricultural or horticultural" requirements under KRS section 132.010 were met.[166]

Agricultural land is a tract of land "of at least ten contiguous acres in area used for the production of livestock, livestock products, poultry, poultry products and/or the growing of tobacco and/or other crops including timber, or where devoted to

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[164] *See supra* notes 92-95 and accompanying text.

[165] H.B. 549, Ky. Gen. Assembly, Reg. Sess. § 7(1)(a) (1982).

[166] KRS § 132.010 (Cum. Supp. 1984).

and meeting the requirements and qualifications for payments pursuant to agriculture programs under an agreement with the state or federal government."[167] There is also a requirement that a certain average annual gross income be produced according to a scale based on the acreage in the farm.[168]

Horticultural land is "any tract of land . . . of at least five contiguous acres in area commercially used for the cultivation of a garden, orchard, or the raising of fruits or nuts, vegetables, flowers or ornamental plants."[169] Horticultural land is also subject to an average annual gross income requirement.[170] These sections of KRS are the legislative codification of section 172A of the Kentucky Constitution which states that "the general assembly shall provide by general law for the assessment for ad valorem tax purposes of agricultural and horticultural land according to the land's value for agricultural or horticultural use."[171]

In most respects, the West Virginia unmined minerals tax[172] is more like HB 92 than HB 549. Under West Virginia law and HB 92, there are no specified exemptions from the unmined minerals tax. Yet, in West Virginia, the Revenue Cabinet does not generally tax minerals beneath farm land.[173] As a result, if a farm meets the regulatory criteria and the taxpayer owns a fee estate in both the surface and mineral estates, then generally the minerals are deemed to have no value for tax purposes.[174] However, if the taxpayer makes use of the minerals, leases the right to extract any portion of the minerals, or if 50% of the income from the property is derived from *any* natural resource, then the owner is taxed on the value of the minerals.[175] The amount of this tax on the farmer (solely due to the existence of the minerals) would be between $7.50 and $20.00 per acre because the property would be classified as "inactive reserves."[176]

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[167] KRS § 132.010(9) (Cum. Supp. 1984).

[168] *Id.*

[169] KRS § 132.010(10) (Cum. Supp. 1984).

[170] *Id.*

[171] KY. CONST. § 172A.

[172] W. Va. Leg. Reg. 11-1A, Series 1A, § 11.04 (1984).

[173] W. Va. Leg. Reg. 11-1A, Series 1A, § 10.05(f)(3), at 10.29 (1985).

[174] *Id.*

[175] *Id.*

[176] According to John Melton, Director of the Ad Valorem Tax Division in West

Since farm land was *de facto* exempted from the unmined minerals tax under HB 549 and under West Virginia law, it would not be surprising if farm land was *de facto* exempted from an unmined minerals tax imposed by HB 92. The *de facto* exemption of farm land from the unmined minerals tax would be constitutional, since it would be based upon KRS 132.010(9) and (10), and section 172A of the Kentucky Constitution, which allow farm land to be valued at its agricultural or horticultural value. The *de facto* exemption would apply since the underlying minerals would add nothing to the agricultural or horticultural value of the farm land.

Under HB 92, minerals underlying property which did not qualify as agricultural or horticultural would be classified and taxed as active mining property, active reserves or inactive reserves.[177] Minerals in the inactive reserve classification would probably, as in West Virginia, be valued at between $200 and $800 per acre, depending upon the quantity, quality and other characteristics of the mineral reserve.

The problem with exempting agricultural and horticultural land from the tax on unmined minerals is that such exemption would presumably be used by every owner of a valuable mineral estate who also owns the surface estate to escape taxation of his mineral estate. It is likely that Eastern Kentucky could develop some of the steepest timber and cattle farms in the United States, perhaps an unforeseen salutary economic development encouraged by taxation of unmined minerals.

If farm land is not exempted from the unmined minerals tax, the consequences could be disastrous for the farm industry. Even a minimum additional property tax of $10 per acre could force some farmers out of farming in today's economy. Many farmers might be forced to obtain the "highest and best use" for their property by selling, leasing or mining the coal under their farm.

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Virginia, inactive reserve values range from $300 to $800 per acre. J. Melton, Presentation to the Kentucky Unmined Minerals Tax Advisory Commission at 31 (1984). Assuming this value was taxed at a rate of 2.5%, the amount of tax would range from $7.50 to $20.00 per acre.

[177] *See supra* notes 103-05 and accompanying text.

Similar problems arise when the farmer is merely the surface owner whose consent is required to strip mine the underlying coal deposits owned by another person. Presumably, the consent power of the farmer would not increase the agricultural or horticultural value of his farm land and thus the surface owner/farmer would be *de facto* exempt from the tax on unmined minerals.[178] The problem caused by the *de facto* exemption of the surface owner/farmer from sharing the burden of the tax on the unmined minerals with the owner of the mineral estate is that the farmer's incentive to consent to strip mining would be seriously impaired. The surface owner/farmer could sit back and wait while the mineral estate owner paid property tax on minerals which he could not strip mine until eventually the owner of the mineral estate might be induced to sell his mineral estate for "peanuts." Under such circumstances, it is evident that the value of the mineral estate is practically nil and should be subject to no tax or a very low tax.[179]

## VII. IMPACT OF TAX ON OTHER UNMINED MINERALS

Coal is by far Kentucky's most important mineral resource.[180] Furthermore, coal underlies about 44% of the entire

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[178] *But see supra* notes, 161-63 and accompanying text.

[179] *Id.*

[180] KY. DEPT. OF ECON. DEV., ENERGY AND NATURAL RESOURCES IN KENTUCKY at vi (1984) [hereinafter cited as ENERGY AND NATURAL RESOURCES]. This table illustrates the value of coal relative to other mineral resources.

1982 MINERAL PRODUCTION IN KENTUCKY

| | Production | Value |
|---|---|---|
| Bituminous Coal[2] | 147,930,000 | 4,502,989,200 |
| Petroleum[3](BBLS) | 7,348,800 | 236,776,000 |
| Natural Gas[3](mcf) | 51,924,000 | 78,830,000 |
| Clays[4](tons) | 591,000 | 3,140,000 |
| Crushed Stone[4](tons) | 29,650,000 | 105,600,000 |
| Sand & Gravel[4] | 4,300,000 | 8,960,000 |
| Gem Stones[4] | N/A | 1,000 |
| Combined Value of Cement (tons), Clays (Ball Clay), Lime[4], Industrial Sand & Gravel & Zinc | XX | 83,085,000 |

state.[181] Although minerals other than coal are presently subject to real property *ad valorem* tax in Kentucky,[182] there is apparently no state-wide extensive mapping and assessment effort being made to effectively tax reserves of unmined minerals. It is likely that such an effort to obtain uniformity of enforcement of the taxation of all unmined minerals would be cost prohibitive.[183] For many of these minerals, the only statewide estimates currently available are "abundant."[184] Valuation of particular deposits, once located, would be difficult and expensive.

Presumably, an unmined minerals tax on coal would have little impact on the taxation of other unmined minerals.[185] Taxation of other unmined minerals is likely to continue as it is

| RESERVES | |
|---|---|
| Bituminous Coal (Reserve Base) (Tons) (1979)[1] | 34,200,000,000 |
| Petroleum (BBLS) (Dec. 1981)[1] | 36,000,000 |
| Natural Gas (mcf) (Dec. 1981)[1] | 551,000,000 |
| Natural Gas Liquids (BBLS) (Dec. 1982)[1] | 25,000,000 |
| Crushed Stone | Abundant |
| Sand & Gravel | Abundant |
| Ball Clay (tons) (Identified Resources) (1980)[2] | 630,000,000 |
| Fire Clay (tons) (Identified Resources) (1980)[2] | 280,000,000 |
| Fuller's Earth (tons) (Identified Res.) (1980)[2] | 750,000,000 |
| Miscellaneous Clays | Abundant |

[1]. Preliminary

[2]. Production includes only mines producing 10,000 tons or more; value is price at mine.

[3]. Source: U.S. Department of Energy

[4]. Source: U.S. Bureau of Mines

[181] ENERGY AND NATURAL RESOURCES, *supra* note 180, at 17.

[182] The exemption from local taxes under KRS § 132.200(11) and the 1/10 cent per $100 value tax rate under § 132.020(5) apply only to coal. *See* Board of Supervisors v. Superior Oil Corp., 276 S.W. 527 (Ky. 1925) (holding oil and gas *leases* subject to taxation at their fair cash value); Lewis, *Is a Lease for Oil and Gas Mining Purposes for a Term of Years Realty or Personalty*, 21 KY. L.J. 188 (1932-33).

[183] As many in the oil and gas business can prove with their "dry holes", the existence of oil or gas under a given tract of land can only be conclusively established by drilling a test well. Other minerals, though not as elusive as oil and gas, are not adequately mapped nor is their commercial value easily determinable.

[184] *See generally* ENERGY AND NATURAL RESOURCES, *supra* note 180.

[185] At least in theory, shale oil deposits are currently subject to ad valorum tax. Since H.B. 92 § 1(18) (1984) defines taxable unmined minerals as those "for which there exists a method of extraction . . . in common usage in the industry and a commercial use for which the mined mineral could be devoted," it is arguable that H.B. 92 would create an exemption from tax for oil shale and tar sands. *See* Note, *Taxation of Unmined Minerals: Is It Inevitable, or Is It Unconstitutional?*, 1 J. MIN. L. & POL'Y 97, 120 (1985).

now, *i.e.*, properties being actively mined will be subject to tax on their fair cash value and other reserves will not be assessed.

## VIII. WHO PAYS THE TAX ON UNMINED COAL

If the mineral estate has not been severed from the surface estate, liability for the tax on unmined minerals would fall upon the fee simple owner of the property.[186] On the other hand, if the mineral estate has been severed from the surface estate by a Broad Form Deed or other conveyance of the mineral estate, the owner of the severed mineral estate would be liable for the tax on the unmined minerals. However, as previously discussed, the value of both the mineral estate and the surface estate would be affected by a power in the surface owner to prevent strip mining, at least for unmined coal which was suitable for strip mining.[187] Also, the value of the surface estate and the mineral estate could be affected by the agricultural and horticultural valuation provisions.

More difficult problems are encountered where the mineral estate is leased to an operator with the reservation of a per ton royalty on coal extracted. Kentucky courts have held that both the reserved royalty and the leasehold estate are taxable properties.[188] Furthermore, in *Commonwealth v. Elkhorn-Piney Coal Min. Co.*,[189] the Kentucky Court of Appeals held that a coal mining leasehold and its appurtenances are real estate for purposes of property taxation. Although a leasehold estate is taxable as real estate, the owners of the leasehold estate (lessees) are not liable for *ad valorem* taxes on unmined coal. The lessees are only taxable on the value of their mining lease and the improvements thereon, where title to the coal is not vested in the lessees until after the coal is mined.[190] Since title to the coal would be

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[186] *But see supra* notes 176-77 and accompanying text (a discussion of agricultural and horticultural value as a *de facto* exemption from the unmined minerals tax). In West Virginia, there is a presumption that the owner of the surface owns the minerals unless he can prove otherwise.

[187] *See supra* notes 161-63 and accompanying text.

[188] Board of Supervisors v. Superior Oil Corp., 276 S.W. 527 (Ky. 1925); Swiss Oil Corp.v. Shanks, 270 S.W. 478 (Ky. 1925); Moss v. Board of Supervisors, 263 S.W. 368 (Ky. 1924); Commonwealth v. Garrett, 260 S.W. 379 (Ky. 1924).

[189] 43 S.W.2d 684 (Ky. 1931).

[190] Head v. Little, 226 S.W.2d 322 (Ky. 1950).

in the owner of the reserved royalty (lessor), it is the lessor who would be liable to the state for the tax on the unmined coal.[191]

Of course, the parties to a coal lease could provide by contract in their lease that as between the lessor and lessee, the lessee would be responsible for and pay any taxes on unmined coal in the leased tract. In *Head v. Little*, the lessee was held not liable for the tax on unmined minerals, since his lease provided that he would "[p]ay . . . all taxes . . . of any name, nature and kind whatsoever . . . on any coal *that may be produced* on the leased premises."[192]

The Kentucky statutes which exempt unmined coal from local taxation[193] and which place a 1/10 cent state tax rate on unmined coal[194] apply to "unmined coal and any interest therein, in whatever form held, including, but not limited to, leasehold and royalty interests."[195] It might appear that the exemption of leasehold estates from property tax goes beyond an exemption from unmined minerals tax since the owner of the leasehold estate is not liable for unmined minerals tax.[196] However, the value of the unmined coal subject to a lease is reflected in both the reserved royalty and the leasehold estate. In effect, the value of the unmined coal may be divided between these two interests, *i.e.*, the value of the reserved royalty is equal to the present value of the future stream of royalty payments which will be generated by production of coal and the value of the leasehold interest (in excess of the value of leasehold improvements) equals the present value of the future profits (net of royalties and costs of production) which will be generated by the production and sale of coal. This amount should equal what a willing buyer would pay for the leasehold interest (in addition to what he would pay for the value of improvements to the leasehold estate).

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[191] In West Virginia, the value of property classified as "active mining property" is determined by multiplying the royalty rate (if possible, the royalty rate of other leasehold transactions in the same county) times a multiplier (set annually by the W. Va. Dept. of Revenue). *See* Dutton & Bratton, *supra* note 53.

[192] *Head*, 226 S.W.2d at 324 (Emphasis added.)

[193] KRS § 132.200(11) (Cum. Supp. 1984).

[194] KRS § 132.020(5) (Cum. Supp. 1984).

[195] *See supra* notes 193-94.

[196] *See supra* note 190 and accompanying text.

It would be unconstitutional to tax the owner of the reserved royalty interest on more than the fair cash value of his reserved royalty interest, *i.e.*, it would be unconstitutional to value the reserved royalty interest as being equal to the value of the unmined minerals in the ground since the value of the minerals in the ground may be much more or much less than the value of the property owned, the reserved royalty interest.[197] The reserved royalty interest (plus a reversion in the event of default by the lessee) is the property owned by the lessor and is the property which must be valued.[198]

Similarly, the leasehold estate is the property owned by the lessee and is the property which must be valued to determine his tax liability. However, the value of the reserved royalty and the value of the leasehold estate may be affected by fluctuations in the value of the unmined minerals. Presumably, at the time a lease is executed, the present value of the reserved royalty rights and other payments to the lessor will equal the value of the unmined minerals.[199] Thus, the entire burden of the tax will be on the owner of the reserved royalty. The value of the lessee's leasehold estate, at the time of execution of the lease, should be zero if the royalty is fair.[200]

As time passes after the execution of the lease, the value of the unmined coal subject to the lease may increase or decrease

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[197] KY. CONST. § 172 requires that property be valued at its "fair cash value" which is the price it would bring at a voluntary sale.

[198] The discussion in the text assumes that the royalty rate set by the parties was bona fide and not the product of collusion between the lessor and lessee, as where, for example, the lessor and lessee are related parties and they have set the royalty rate unreasonably high or low to shift income to one or the other of them. Cases involving setting of the value of an interest in a closely held business for Federal estate tax purposes through the use of a buy-sell agreement appear to be relevant in determining the bona fides of the royalty rate set in the above situation. This analysis also leads one to conclude that the West Virginia practice of valuing the reserved royalty interest on the basis of royalty rates on comparable properties (rather than the actual royalty rate on the property to be valued), would be unconstitutional in Kentucky because it would not represent the price at which the actual reserved royalty could be sold in a voluntary sale, but represents the current value of the entire interest in the unmined minerals. *See supra* text accompanying note 190.

[199] The value of unmined minerals is the fair cash value which would be realized on a voluntary sale of the unmined minerals.

[200] Of course, the leasehold estate might have some value representing acquisition costs, bonuses or prepayments.

due to factors other than physical depletion of the coal reserves. These fluctuations in value may affect the value of the reserved royalty or the value of the leasehold estate or both. If unmined coal decreases in value, the value of the leasehold estate would probably decrease, especially if the royalty to be paid by the lessee was a fixed rate per ton. If the value of the unmined coal increases, the value of the leasehold estate would probably increase because now the fixed royalty rate represents a bargain purchase. Although the primary effect of changes in the value of unmined coal will be on the lessee, it is possible that such a change in value of the unmined coal could impact on the value of the reserved royalty, *e.g.*, to the extent a change in value of the unmined coal accelerates or decelerates mining out the coal and payment of royalties to the lessor.

Under the above analysis, the economic burden of the unmined minerals tax may be shared by the lessor and the lessee of the minerals. Each would pay property tax on a share of the value of the unmined coal reflected in valuing their respective interests. Even though the lessor is the legal owner of the unmined coal according to Kentucky law, through the lease he has given the lessee an economic interest in the unmined coal and taxation must reflect these economic realities.

## IX. ECONOMIC INCIDENCE OF THE TAX ON UNMINED COAL

### A. *Owners and Lessors of Mineral Interests*

Although the owner of fee title to lands containing coal or to unmined minerals *pays* the property tax on those minerals, can the owner shift the burden of the tax to the lessee through a lease? Prevailing economic theory is that the owner cannot shift the tax burden to others.[201] Assuming a competitive market, the present value of his reserved royalties under any lease the owner executes in an arms-length, bona-fide transaction could not exceed the fair market value of the unmined minerals. Once enacted, the tax burden would be capitalized into the value of unmined coal, causing an almost immediate decline in the value of unmined coal.

[201] *See, e.g.*, A. M. CHURCH, TAXATION OF NONRENEWABLE RESOURCES 107 (1981).

For example, assume that a coal deposit, currently *de facto* exempt from property tax, is estimated to be mineable over the next 20 years and is worth $100,000, *i.e.*, the present discounted value of the after-tax stream of income which the coal will produce over the next 20 years is $100,000. Further assume that an unmined coal tax is enacted subjecting unmined coal to property tax at the rate of 70 cents per $100 value. Thus, the owner of the unmined coal will have to pay property taxes of about $700 on his coal in the current year. As the coal is depleted from the ground each year, the value of the unmined coal will decline as will the property tax payable. Thus, assume that over the 20 year period the owner will pay a total of $8000 in property taxes on this unmined coal.[202] The present value of the unmined coal must be discounted after enactment of the property tax to reflect these future property tax liabilities. The present value of the $8,000 in future property tax payments must be subtracted from the $100,000 before-tax value of the unmined coal in order to determine the present value of the coal deposit immediately after enactment of the property tax.[203]

In summary, assuming that the demand for coal will remain elastic and that there is a competitive market for unmined coal,[204] the burden of the property tax paid by the mineral owner will fall on the mineral owner and he will not be able to shift any substantial portion of that burden to labor, consumers, or operators. The tax burden on the mineral owner will decrease the value of his mineral interest. This decline in the value of the coal deposits could increase if proposed changes in the Federal Income Tax law are enacted.

### B. The Lessee of Unmined Minerals

The value of a leasehold estate where the lease provides for a fixed per ton royalty, will increase in value if the value of

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[202] Taxes each year would decrease as the value of the property decreases due to mining.

[203] The exact amount of the tax in the first year depends on the value of the unmined coal and the value of the unmined coal in the first year depends on the amount of tax, requiring the use of simultaneous equations to determine the exact amount of tax and exact value of the unmined coal.

[204] Arguably, if the unmined coal is owned by a Utility Company, such company might be able to pass through the additional tax to its consumers.

unmined coal increases after the execution of his lease.[205] Thus, the lessee will pay property tax on such increase in value of his leasehold estate, assuming that present law exemptions are repealed or held unconstitutional. Furthermore, the lessee/operator cannot shift this tax burden to consumers, because the demand for coal is elastic and any price increase by one group of producers will result in a proportionate reduction in the demand for coal supplied by that group. Thus, the additional tax costs could not be passed on to consumers, again assuming competitive markets, *i.e.*, that the operator is not selling the coal under a long-term, cost plus contract and that the operator is not a utility company.

However, the operator may be able to shift the additional tax costs to labor and the lessor. Whether the operator can shift these tax costs to labor depends on the relative bargaining power of the operator and labor. Significant factors to be considered include whether labor is unionized, what the unemployment rate is, and how mobile the labor force is. Even though the lessee is tied by his present contract to fixed royalty rates, it is possible in the long-run to shift some of this tax burden to lessors of unmined coal. One simulation of tax incidence predicts that a 10 percent change in the tax on output (like a tax on the lessee-operator) would be shifted equally between labor and lessors of mineral interests with only about a one percent increase in prices to consumers.[206]

### C. *Estimated Revenues from Tax on Unmined Coal*

Estimates of the revenue which would be produced by a tax on unmined coal depend on assumptions regarding the structure of the tax imposed and the manner of its administration. At present, unmined coal is exempt from all local[207] property taxes.[208] The *Moore* decision that the 1/10 cent state tax rate on unmined coal constitutes an unconstitutional *de facto* exemption of un-

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[205] *See supra* text accompanying note 199.

[206] CHURCH, *supra* note 201.

[207] County, city and school district.

[208] KRS § 132.200(11) (Cum. Supp. 1984); KY. CONST. § 171.

mined coal from *state* property tax[209] does not subject unmined coal to local property taxes. On the other hand, HB 92 would repeal KRS section 132.200(11), the provision which currently exempts unmined coal from local taxation. Under HB 92, unmined coal would be subject to state property tax at the general rate applicable to real property and would also be subject to local property taxation.

Local tax rates vary, thus subjecting unmined coal in different locations to differing tax burdens. For estimating purposes, a local tax rate of 42 cents per $100 of value is assumed in addition to the state tax rate of 22 cents per $100[210] or a total property tax burden of 64 cents per $100 of value. Of course, if unmined coal were to continue to be exempt from local taxes, the total tax burden would be only 22 cents per $100 of value. If unmined coal were exempt from state taxation and only subject to local taxation as occurs in many states taxing unmined coal,[211] the total tax burden would be approximately 42 cents per $100 of value.

To estimate revenues from a tax on unmined coal, it is necessary to estimate the total market value of unmined coal in Kentucky which would be subject to the tax. From the measured coal resources of 64 billion tons,[212] it is necessary to determine how much of this coal would be subject to the tax. Assuming that coal under rivers, barns and state parks will produce negligible revenue and further assuming that special farm valuation[213] and/or the Broad Form Deed consent requirement for strip mining[214] will further reduce coal reserves taxable at anything near fair cash value, it is necessary to estimate the amount of property thus *de facto* exempted from the tax. It is probably not unreasonable to estimate that 50% of the estimated coal reserves are now or would soon be exempt under one of the

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[209] Moore v. Gillis, No. 84-CI-0867, slip op. (Ky. Franklin Cir. Ct. filed July 10, 1985).

[210] 1984 rates under the roll-back provision.

[211] "Of the states that tax unmined coal, the majority tax only on the local level. . . ." Dutton & Bratton, *supra* note 53, at 18.

[212] Kentucky Geological Survey, *Kentucky Coal Reserves*, Ky. Coal J., Aug. 1985, at 3 (total measured, indicated and estimated coal reserves).

[213] *See supra* text accompanying notes 176-77.

[214] *See supra* text accompanying notes 161-63.

above "exemptions" from meaningful tax, leaving 32 billion tons subject to the tax.

Of the 32 billion taxable tons remaining, it is necessary to estimate how much is recoverable through mining. A rate of 90% for strip mining and 50% for deep mining is reasonable, but such recovery rates are arguably high to apply to all the remaining reserves of unmined coal in the state for purposes of a taxing statute. Persons view recovery rates differently when selling coal reserves than when self-assessing their property for tax purposes. Since approximately one-half of Kentucky's coal could be strip mined and one-half could be deep mined, a recovery rate of 70% and a tax recovery rate of 50% appear reasonable. Applying the 50% recovery rate to the 32 billion tons of "non-exempt" coal reserves leaves 16 billion tons of recoverable, taxable coal.

Next, an average value per ton of coal in the ground must be ascertained in order to estimate the fair cash value of the 16 billion tons of recoverable coal. Although 50 cents per ton is the figure most commonly used in valuing coal in the ground,[215] West Virginia's experience in implementing a property tax on unmined coal similar to HB 92 was that "effective value per ton . . . ranged from 3.0 cents to 21.7 cents per ton" with a median value of 13.0 cents per ton.[216] Assuming a 25 cents per ton average value for Kentucky coal, the fair cash value of unmined coal in Kentucky would be assessed at $4 billion.

Applying the state property tax rate (22 cents/$100) and the estimated local rates (42 cents/$100) produces total tax revenues of $25.6 million per year.[217] Almost nine million in state revenues and $16.8 million in local revenues would be generated.[218] These

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[215] *See, e.g.*, Virginia Wilson, Economic Analysis of a Proposed Property Tax on Unmined Minerals in Kentucky, Occasional paper No.1 at 15 (Jan. 1983). Note also that the value of unmined coal would decline with enactment of a tax on unmined coal. Further reductions in value could result from Federal income tax changes.

[216] Dutton & Bratton, *supra* note 53, at 32.

[217] It should be noted that not all counties will share equally in these new revenues: 15 counties would get about 80% of the local revenues; 5 counties would get about 40% of the local taxes. The 15 counties are: Breathitt, Floyd, Harlan, Henderson, Hopkins, Knott, Leslie, Letcher, McLean, Martin, Muhlenberg, Perry, Pike, Union and Webster. The 5 counties are: Henderson, Hopkins, Pike, Union and Webster.

[218] These estimates are based upon the following calculations:

estimates can be compared with the West Virginia experience as one test of validity. With a similar unmined coal base, about 100 billion tons, assessment at 60% of value and a tax rate averaging 2.24%, West Virginia collected $11.2 million in taxes on unmined minerals in 1982.[219]

Others have arrived at very different estimates of the current taxable value of Kentucky's in ground coal.[220] A small increase in the average per ton value or non-exemption of coal under the farm land valuation provision or unconstitutionality of the Broad Form Deed, could have a fairly substantial effect on the $25.6 million revenue estimate.

### D. *Secondary Revenue Effects*

A tax on unmined coal could have significant effects on severance tax collections,[221] sales tax revenues and state income taxes. Such secondary revenue effects would be directly related to increases or decreases in coal production which would cause increases or decreases in employment in Kentucky. If coal production increased, severance tax collections, employment, sales tax revenues and income tax revenues would increase. If coal production decreased, severance tax collections, employment, sales tax revenues and income tax revenues would decrease.

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Estimated Revenues from Unmined Minerals Tax

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|---|---|
| Measured reserves | 64 billion tons |
| less: de facto exempt | 32 billion tons |
| Subject to tax reserves | 32 billion tons |
| times: recovery rate | 50% |
| Taxable Reserves | 16 billion tons |
| times:25 cents/ton value | 25 cents |
| Market Value of Unmined Coal | $4 billion |
| times: 22 cent state tax rate | $8.8 million |
| 42 cent local tax rate | 16.8 million |
| TOTAL REVENUES GENERATED | $25.6 million |

Note: This total is not adjusted for the 96% collection rate on real property taxes or the estimated costs of administration of the tax ($500,000).

[219] S. Clark, Memorandum, Statutory Incidence of an Unmined Minerals Tax 2 (Oct. 31, 1983).

[220] *E.g.*, Gilmore Dutton - $8.2 billion; Virginia Wilson - $16.375 billion at 50% recovery rate; Fair Tax Coalition - $22.4 billion at 50% recovery rate.

[221] Severance Tax Collections for the calendar year 1984 were $211,232,276. Ky. Coal J., Nov. 1985, at 43.

The beneficial effects of increased coal production and employment would be enhanced by the multiplier effect. The coal industry provides a substantial portion of the state's total earnings and labor force.[222] However, due to a weak link between the coal industry and the rest of the economy, the multiplier effect is rather small.[223] Thus, a mining operation in Harlan County has little impact on the Kentucky economy outside of Harlan County.

On a regional level, the coal industry can have a significant impact. This is especially true in Eastern Kentucky where "[t]he coal industry directly produces more than half of the gross regional product and one fourth of private sector employment. As a result, fluctuations in the demand for coal . . . produce marked impact upon the coal counties."[224] Thus, "[i]f the export demand for coal increases by 5 percent annually over the historical rate of growth," employment in the area could be expected to increase 4.8 percent.[225]

Whether imposition of a property tax on unmined coal would cause an increase or a decrease in coal production (in comparison to coal production in the absence of such tax), depends upon the identity of the group which bears the burden of the tax. There are, in general, three groups that may find themselves ultimately saddled with the burden imposed by a tax on unmined coal. They are the owners of the unmined coal, the coal operators and the consumers of coal.

If the tax burden were on the owners of unmined coal, owners would be induced to "mine out from under the tax burden," *i.e.*, reduce the amount of taxable property as quickly as possible by severing it from the earth, and thereby avoiding future taxes. Owners would be motivated to accept lower roy-

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[222] For example, data provided by the Kentucky Economics Information System shows that, in 1984, coal wages and salaries alone were 5.7% of total wages and salaries in Kentucky.

[223] J. ABELL, KENTUCKY ENERGY CABINET, AN ANALYSIS OF ENERGY RELATED MULTIPLIERS IN KENTUCKY 19 (Aug. 1983).

[224] Sherafat, Pagoulatos & Anschel, *The Exploitation of Coal as an Engine for Growth in Eastern Kentucky - An Input-Output Study*, 10 S.J. AGRIC. ECON. 81, 85 (1978).

[225] *Id.* Because of the recent trend toward greater mechanization of the coal mining process, the 4.8% employment increase may be slightly optimistic.

alties in order to induce mining of their coal.[226] This apparent anomaly of increased costs resulting in increased production is explainable by the fact that the increased tax costs to the owner results in lower royalty costs to the lessee-coal producer. Since future values of coal are speculative,[227] owners of coal might be tempted to mine out from under the tax for extremely low royalties or even abandon their coal properties, but such drastic results have apparently not occurred in other states which have imposed property taxes on unmined coal.

Although short term consequences of saddling owners with the tax burden of an unmined minerals tax would likely accelerate coal production, there are several arguments that such a tax burden would result in long term decreases in coal production. First, owners would delay exploration, for such exploration could lead to an increase in an owner's coal reserves and consequently an increase in his tax liability.[228] However, since coal reserves in Kentucky are extensively mapped and, for the most part, already owned, the impact of the tax on exploration is likely to be negligible.

Secondly, it is arguable that there would be a tendency for owners to delay opening new mines to avoid reclassification of reserves from inactive to active reserves. Because of the significantly lower tax rate on inactive reserves, there would be a tendency to completely mine out existing coal reserves before opening a new tract.

Third, short-term overproduction of coal would cause coal prices to decline because of the elasticity of demand for coal. Thus, some coal which could economically be mined at the price at the original level of supply would not be economically mineable at the lower price level resulting from the increased supply

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[226] *See* V. Wilson, *infra*, note 229, at 9-13 (citing A. CHURCH, TAXATION OF NON-RENEWABLE RESOURCES (1981)). Counteracting this financial motivation to lower royalties for economic reasons would be the psychological justification to raise royalties to recover the new tax burden. Presumably, economic realities would prevail over feelings of fairness.

[227] Although coal prices may increase as the supply dwindles, coal prices could decline precipitously with the development of a cheap, safe alternate energy source, e.g., from hydrogen, solar, shale oil or nuclear fuels.

[228] CHURCH, *supra* note 201, at 75.

of coal.[229] Thus, there would be a tendency to prematurely abandon costly mines, leaving coal reserves which are not likely to be mined in the future because of high start-up costs.[230] As coal supplies are exhausted, presumably the original price levels would be restored, but it may take some time to restore the prior level of capital investment in coal mining.

Some of the burden of tax on unmined minerals can be expected to rest upon operators for either of two reasons. First, if the coal lease provides that the operator is liable for all taxes,[231] then the tax might be shifted to the operator, at least under certain existing leases. Secondly, the operator's tax burden could be increased due to increased value of his leasehold estate resulting from rising coal prices and a fixed royalty rate under his lease.[232]

If the tax burden were on the operator, the operator might accelerate production on existing leases to reduce the tax burden and might shift future production to other states in which production costs (including tax burdens) were lower. For the operator, his share of the burden of the unmined minerals tax would be similar in effect to an additional severance tax, *i.e.*, an additional production cost. One estimate of such a tax, at a rate of 60 cents per $100 value of unmined coal (value at 16 cents per ton), assuming the tax burden capitalized at 15% was shifted to the operator, would have the following impact on Kentucky coal production:

1985

Eastern Ky. coal production....320,000 ton decrease
Western Ky. coal production........No change 1990
Eastern Ky. coal production....290,000 ton decrease
Western Ky. coal production..2,940,000 ton decrease[233]

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[229] V. Wilson, *Economic Analysis of a Proposed Property Tax on Unmined Minerals in Kentucky* 8-9 (Jan. 1983) (The Appalachian Center Student Internship Program, Occasional Paper Series No. 1).

[230] *Id.* at 9. The tendency to delay opening new reserves to avoid reclassification as active reserves may offset this tendency to premature abandonment of existing mines.

[231] *See supra* text accompanying note 192.

[232] *See supra* note 195 and accompanying text.

[233] R. Sims, An Analysis of Coal Production Impacts Resulting from a Property Tax on That Mineral 3 (n.d.).

Because of the elasticity of demand for coal, it is fair to assume that the burden of a property tax on unmined coal cannot be shifted to consumers, except in a few limited situations, *e.g.*, unmined coal owned by a public utility company whose rates reflect costs plus a reasonable profit.

Since more than 50% of Kentucky's unmined coal is likely owned by non-residents,[234] and about 85% of Kentucky's coal is exported, a substantial portion of the burden of a tax on unmined coal, that which falls on owners or consumers, would be exported. To the extent that the burden of the tax falls on coal operators, the burden may fall on Kentucky residents.

## Conclusion

Is the accurate evaluation of unmined coal impossible or is a "rough, educated guess" a better valuation than zero value? Does immediate imposition of the estimated future tax burden on the current coal owner (through reduction in the present value of his unmined coal) justify special treatment for unmined coal? Should it matter whether or not most unmined coal is owned by foreign corporations whose stock is owned mainly by non-residents of Kentucky? Should small or large landowners be exempted from the tax because their surface estate qualifies for agricultural or horticultural exemption? Should surface estate owners be exempted from the tax if they do not own the mineral estate, even though the surface estate owner might be able to obtain a larger royalty for consenting to strip mining than the mineral estate owner could obtain for leasing his mineral estate? Should a possible net loss in state revenues, *e.g.*, greater decrease in severance tax, sales tax and income tax collections than increase in state property tax revenues justify not subjecting valuable property to property tax? Does it matter that most of the property tax revenues generated, if unmined coal is subjected to local taxation, would go to a few counties and local school districts? These and other value choices emerge from the legal-economic analysis of imposition of property taxes on unmined

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[234] *See* Wilson, *supra* note 229, at 13; H. Caudill, A Position Statement Taxation of Unmined Coal Reserves in Kentucky, 2 (Dec. 12, 1983) (copies mailed to Kentucky Unmined Minerals Tax Advisory Commission).

coal. Legislators, trying to decide whether or not to change the property tax scheme for unmined coal and other minerals must make these value choices.